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ACTION AF-06

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INFO AMCONGEN ASMARA

AMEMBASSY LONDON

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DEPT PASS DOD ISA/ASD

E.O. 11652: N/A

TAGS: ECON EAID EFIN MASS MPOL ET US

SUBJECT: ECONOMIC EFFECTS OF PROJECTED ETHIOPIAN MILITARY
PROCUREMENT

SUMMARY

A. THE EMBASSY HAS ASSESSED THE ECONOMIC IMPLICATIONS OF THE
EPMG'S APPARENT INTENTIONS REGARDING PURCHASE OF US MILITARY
GOODS AND SERVICES. THE EMBASSY'S ANALYSIS IS FULLY DEVELOPED
IN A-17, WHICH WILL BE POUCHED TO THE DEPARTMENT ON FEBRUARY 5.

B. ACCORDING TO INFORMATION CURRENT AVAILABLE, THE EPMG HAS
INDICATED INTEREST IN MILITARY PROCUREMENT ACTIONS WHICH COULD
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RESULT IN THE ADDITIONAL EXPENDITURE OF AS MUCH AS US\$200 MILLION

OVER THE NEXT 5 YEARS FOR CAPITAL, O&M SUPPORT, AND INTEREST COSTS. BASED ON OUR ANALYSIS WE BELIEVE THAT IT IS ECONOMICALLY FEASIBLE FOR ETHIOPIA TO SUPPORT MILITARY PROCUREMENT LEVELS OF THIS MAGNITUDE IN THE SHORT RUN. THIS CONCLUSION IS BASED PRIMARILY ON ETHIOPIA'S STRONG FOREIGN EXCHANGE RESERVE POSITION, FAVORABLE BALANCE OF PAYMENTS OUTLOOK, AND VERY SMALL INTERNAL (DOMESTIC) DEBT. WHILE IT IS POSSIBLE THAT CHANGES IN FOREIGN EXCHANGE RESERVES AND INFLATIONARY CONDITIONS COULD ALTER THE OUTLOOK, WE BELIEVE THAT, WITH CAREFUL MANAGEMENT AND REASONABLE ECONOMIC CONDITIONS, ETHIOPIA COULD EVEN COPE OVER THE LONGER RUN. END SUMMARY.

1. IN VIEW OF CONTINUED EPMG INTEREST IN PROCURING LARGE AMOUNTS OF US MILITARY GOODS AND SERVICES, THE EMBASSY DECIDED THAT IT WOULD BE USEFUL TO ANALYZE THE CONOMIC IMPACT OF THE MILITARY PROCUREMENT ACTIONS WHICH THE EPMG, AS OF JAN 20, HAS INDICATED INTEREST IN ARRANGING THROUGH FMS CASH AND CREDIT PROCEDURES. THIS APPROACH WAS ADOPTED BECAUSE THE AMOUNTS INVOLVED ARE BASED ON THE BEST INDICATIONS WE HAVE REGARDING EPMG MILITARY PROCUREMENT INTENTIONS. IT SHOULD NOT BE ASSUMED THAT THESE PROCUREMENT ACTIONS CONSTITUTE A COHERENT PROGRAM OR THAT THEY WERE DEVELOPED AFTER CAREFUL, COORDINATED THOUGHT BY THE EPMG. THEY DO, NEVERTHELESS, PROVIDE A REASONABLE BASIS FOR ASSESSING THE ECONOMIC IMPLICATIONS OF EPMG'S CURRENT MILITARY PROCUREMENT PLANS AND THE ANALYSIS CAN BE ADJUSTED TO REFLECT FUTURE CHANGES AS THEY OCCUR.

2. TABLE A REFLECTS OUR GROSS ESTIMATES OF PROJECTED OUTLAYS (IN 1975 DOLLARS) THE ETHIOPIANS WILL HAVE TO MAKE OVER THE NEXT FIVE YEARS FOR THE ITEMS THEY WISH TO BUY INCLUDING CAPITAL, &M AND SPARE PARTS COSTS. THIS TABLE IS FOR PLANNING PURPOSES ONLY SINCE IT IS BASED ON A NUMBER OF ASSUMPTIONS CONCERNING PROCUREMENT AND DELIVERY DATES AND O&M SUPPORT LEVELS WHICH ARE SUBJECT TO CHANGE.

TABLE A
MILITARY PROCUREMENT - CASH AND CREDIT
(\$US THOUSANDS)

F5E (16)	--	--	16,500	17,300	20,300
MISSILES					
(126 AIM-9B)	304	470	70	70	70
VULCAN					
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(18SP & 20TWD)	--	27,016	1,500	1,500	1,500
RADAR					
(2TPS 43D)	--	14,000	2,000	2,000	2,000
TANKS (36M-60)	689	3,304	7,399	9,108	9,227
APCS (77 M113)	3,896	865	8,065	2,665	2,665
HOWITZER					
(12M109	257	1,126	1,454	1,437	1,421
TOW (12 LAUNCHERS					

260 MISSILES)	--	61	361	690	869
OTHER	1,275	10,571	1,731	9,410	8,598
TOTAL	6,421	57,413	39,080	44,180	46,650

THE GRAND TOTAL FOR FY-75 - FY-79 PROGRAM IS US\$193.7 MILLION OR
ETH\$397.2 MILLION

3. ECONOMIC IMPLICATIONS. THE ECONOMIC IMPACT OF THIS PROCUREMENT INVOLVES ETHIOPIA'S FOREIGN EXCHANGE POSITION AND ITS DOMESTIC BUDGET.

A. FOREIGN EXCHANGE

1. ETHIOPIA IS CURRENTLY ENJOYING AN EXTRAORDINARILY FAVORABLE BALANCE OF PAYMENTS POSITION AND AS A RESULT ETHIOPIA'S FOREIGN EXCHANGE RESERVES HAVE REACHED UNPRECEDENTED LEVELS. THEY WERE APPROXIMATELY ETH\$700 MILLION AS OF JANUARY 1, 1975 AND PRELIMINARY ESTIMATES FOR CY-75 PROJECT A FURTHER INCREASE OF FROM ETH\$80-150 MILLION (NOT INCLUDING THE PROJECTED MILITARY PURCHASES).

2. GIVEN THE REMARKABLE LEVEL OF FOREIGN EXCHANGE RESERVES AND FAVORABLE SHORT-RUN BALANCE OF PAYMENTS OUTLOOK, THE FIRST TWO OR THREE YEARS OF MILITARY PURCHASES WOULD HAVE LITTLE OR NO DVERSE EFFECT ON ETHIOPIA'S EXTERNAL POSITION. EVEN IN THE LONGER TERM, THE IMPACT OF THESE PURCHASES MIGHT NOT UNDULY STRAIN ETHIOPIA'S RESERVES. BUT, FOR THIS HAPPY SITUATION TO BE THE CASE, ONE MUST ASSUME THAT (A) ETHIOPIA'S EXPORTS DO NOT SERIOUSLY DECLINE, (B) ALL OR ALMOST ALL OF THE FX COSTS OF ITS DEVELOPMENT PROGRAM ARE CONTRIBUTED BY OTHERS, (C) ETHIOPIA'S BALANCE OF PAYMENTS REMAIN IN SURPLUS AND (D) NO FURTHER LARGE SCALE MILITARY PURCHASES ARE UNDERTAKEN. ALL OF THESE CONDITIONS MAY BE MET BUT IT IS JUST AS LIKELY THAT THEY WILL NOT BE. IF NOT, THEN THE ACCEPTABILITY OF THE LONGER TERM RISKS INVOLVED IN THESE PURCHASES IS LARGELY LIMITED OFFICIAL USE

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DEPENDENT ON ETHIOPIA'S ABILITY TO MANAGE ITS EXTERNAL POSITION. ONE MEANS OF COPING WITH A DETERIORATING BALANCE OF PAYMENTS POSITION WOULD BE TO CLOSELY CONTROL (I.E., REDUCE) IMPORTS AND SHORT-TERM CAPITAL OUTFLOWS WHICH WOULD REQUIRE A VERY STRONG GOVERNMENT TO IMPLEMENT.

B. LOCAL CURRENCY BUDGET

1. UNDER ORDINARY CIRCUMSTANCES A GOVERNMENT MUST FINANCE ITS EXPENDITURES FOR FOREIGN PROCUREMENT BY PURCHASING FOREIGN EXCHANGE FROM THE CENTRAL BANK WITH LOCAL CURRENCY FROM ITS BUDGET. ETHIOPIA, LIKE MANY OTHER DEVELOPING COUNTRIES , HAS GREAT DIFFICULTY IN MOBILIZING REVENUE, ESPECIALLY THROUGH THE TAX SYSTEM. CONSEQUENTLY, ALTHOUGH THE FX MAY BE AVAILABLE FOR FOREIGN PROCUREMENT THE LOCAL CURRENCY COUNTERPART OFTEN IS NOT. THIS IS ETHIOPIA'S FUNDAMENTAL PROBLEM - WHERE WILL IT OBTAIN

THE LOCAL CURRENCY IT NEEDS TO BUY FX FROM THE NATIONAL BANK TO
USE FOR MILITARY PURCHASES? WE HAVE CONSIDERED AND REJECTED THE
FOLLOWING POSSIBILITIES: THIRD COUNTRY GRANT OR CREDIT
FINANCING, THE EMPEROR'S FOREIGN ASSETS, REALLOCATION FROM THE
GOE'S CAPITAL BUDGET, INCREASED TAX REVENUES, AND CONFISCATION
OF THE NATIONAL BANK'S FX HOLDINGS. RATHER, WE BELIEVE A
DEFICIT FINANCE PROGRAM WILL BE USED TO PROVIDE THE REQUIRED
LOCAL CURRENCY BECAUSE IT IS ECONOMICALLY VIABLE IN THE
SHORT RUN AND IT IS IN ACCORD WITH NORMAL FISCAL PRACTICE.

2. FOR PURPOSES OF PERSPECTIVE TABLE B RELATES DEFENSE
EXPENDITURES TO TOTAL EXPENDITURES AND TO GNP WHILE TABLE C
PROJECTS THE DEFICIT FINANCING REQUIRED TO MET THE GAP BETWEEN

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FM AMEMBASSY ADDIS ABABA

TO SECSTATE WASHDC 2886

INFO AMCONGEN ASMARA

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REVENUES AND EXPENDITURES AND THE COST OF SERVICING THIS DEBT.

TABLE B

(ETHIOPIAN \$ IN MILLIONS)

	TOTAL EXPENDITURES	NATL DEFENSE	NATL DEFENSE AS PERCENT OF	NATL DEFENSE AS PERCENT OF GNP
	TOTAL EXPENDITURES			
FY-75	822.3	159.1	19.3 PERCENT	3.0 PERCENT
FY-76	1011.3	278.6	27.6 PERCENT	5.1 PERCENT
FY-77	1067.0	257.6	24.1 PERCENT	4.5 PERCENT
FY-78	1180.5	286.3	24.3 PERCENT	4.8 PERCENT
FY-79	1299.4	311.5	24.0 PERCENT	5.0 PERCENT

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TABLE C

(ETHIOPIAN \$ IN MILLIONS)

	TOTAL EXPENDITURES	CURRENT REVENUE	TOTAL DEFICIT	ANNUAL IN- CUMULA- TIVE OUT- STANDING DEBT	ANNUAL IN- CUMULA- TEREST
FY-75	822.3	2690.7	-131.6	291.1	11.3
FY-76	1011.3	776.3	-345.0	526.0	20.4
FY-77	1067.0	872.6	-194.4	720.3	31.2
FY-78	1180.5	980.8	-199.7	920.1	41.0
FY-79	1299.4	1102.4	-197.0	1117.0	50.9

AS THE TABLES ILLUSTRATE, MILITARY EXPENDITURES GROW AS A PERCENTAGE OF TOTAL BUDGET EXPENDITURE BUT LEVEL OFF AT ABOUT 24 PERCENT. THE DOMESTIC DEBT RISES DRAMATICALLY BUT FROM A VERY LOW BASE (ETH\$150 MILLION) SO THAT THE SERVICING COSTS ARE QUITE MODEST. CONSEQUENTLY, FROM A BUDGETARY STANDPOINT, THE DEFICIT FINANCE REQUIRED FOR THE MILITARY PROCUREMENT (AND A DEVELOPMENT PROGRAM) IS MANAGEABLE.

3. THE INFLATIONARY EFFECT ON THE ECONOMY IS ANOTHER MATTER AND DEPENDS IN PART ON HOW THE DEFICIT FINANCE PROGRAM IS MANAGED. IF THE MONEY SUPPLY REMAINS THE SAME (I.E., THE GOE BORROWS FROM THE CENTRAL BANK) THERE SHOULD BE PRACTICALLY NO INFLATIONARY EFFECTS IN THE SHORT RUN ALTHOUGH INFLATIONARY PRESSURES MAY BUILD UP OVER THE LONGER RUN. ON THE OTHER HAND IF THE MONEY SUPPLY IS REDUCED (E.E. THE GOE BORROWS FROM THE PUBLIC), THE EFFECT COULD BE DEFLATIONARY (OR AT LEAST NEUTRAL) IN THE SHORT AND POSSIBLY EVEN THE LONG RUN. THE RELATIVELY WEAK LEVEL OF DEMAND AT PRESENT FOR BOTH CONSUMER AND INVESTMENT GOODS (DUE PRIMARILY TO THE POLITICAL SITUATION) ALSO MAKES IT EASIER FOR THE GOVERNMENT TO CONTROL INFLATIONARY TENDENCIES AND, AS LONG AS IT CONTINUES AND THE GOVERNMENT EMPLOYS APPROPRIATE MONETARY AND FISCAL POLICIES, INFLATION SHOULD NOT BECOME A MAJOR

PROBLEM. THE REAL RESOURCE EFFECT OCCURS THROUGH DISSIPATION OF FOREIGN EXCHANGE RESERVES WHICH MIGHT OTHERWISE BE USED FOR CONSUMPTION OR INVESTMENT PURPOSES. THIS BEING THE CASE, A LONGER RUN INFLATIONARY EFFECT COULD ARISE. FOREIGN EXCHANGE RESERVES USED FOR MILITARY PROCUREMENT WILL NOT BE AVAILABLE FOR IMPORTS TO OFFSET LIMITED OFFICIAL USE

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POSSIBLE INFLATIONARY EXCESS DEMAND IN THE FUTURE.

4. SOME TENTATIVE CONCLUSIONS.

A. IN VIEW OF THE FOREGOING ANALYSIS, THE EMBASSY CONCLUDES THAT THE PROJECTED LEVEL OF MILITARY PROCUREMENT IS ECONOMICALLY VIABLE OVER THE NEXT TWO TO THREE YEARS AND, WITH CAREFUL MANAGEMENT AND REASONABLE ECONOMIC CONDITIONS (DOMESTICALLY AND INTERNATIONALLY), ETHIOPIA COULD EVEN COPE OVER THE LONGER RUN. THESE RATHER REMARKABLE CONCLUSIONS ARE BASED PRIMARILY ON ETHIOPIA'S STRONG FOREIGN EXCHANGE RESERVE AND BALANCE OF PAYMENTS POSITION AND ITS VERY LOW LEVEL OF INTERNAL (DOMESTIC) DEBT. SUPPORTING (BUT SECONDARY) REASONS INCLUDE ETHIOPIA'S ABILITY TO ATTRACT AID DONORS AND THE ECONOMIC MANAGEMENT SKILLS OF ITS TOP CIVIL SERVANTS.

B. ALTHOUGH THE GOE COULD UNDERTAKE THE PROJECTED LEVEL OF MILITARY PURCHASES, WHETHER IT SHOULD IS ANOTHER MATTER INVOLVING POLITICAL AND MILITARY AS WELL AS ECONOMIC CONSIDERATIONS. FROM THE ECONOMIC STANDPOINT TWO CRUCIAL ISSUES STAND OUT: (1) WHAT ARE THE ALTERNATIVE USES FOR THESE FUNDS AND (2) WHAT WILL BE THE IMPACT OF THIS PROCUREMENT PROGRAM ON ETHIOPIA'S TRADITIONAL AID DONORS. REGARDING THE FIRST, THE LOGICAL ALTERNATIVE USE IS FOR DEVELOPMENT PROGRAMS. BUT IN THE PAST ETHIOPIA HAS NOT FACED A RESOURCE (ESPECIALLY FOREIGN EXCHANGE) SHORTAGE (ALTHOUGH RECENTLY THERE ARE INDICATIONS THAT PROJECTS ARE READY TO GO BUT FULL FUNDING IS NOT AVAILABLE). RATHER, MOST OBSERVERS BELIEVE ETHIOPIA'S GREATEST CONSTRAINT HAS BEEN ABSORPTIVE CAPACITY. CONSEQUENTLY, THE GOE MAY BE JUSTIFIED WHEN DECIDING THAT IT HAS SURPLUS FUNDS WHICH THE MILITARY COULD PUT TO MORE EFFICIENT USE THAN COULD THE DEVELOPMENT PROGRAM. THIS WOULD BE CONTINGENT, HOWEVER, ON CONTINUED AVAILABILITY OF DEVELOPMENT FUNDS FROM DONORS - WHICH RAISES THE SECOND ISSUE, DONOR REACTION TO A MASSIVE INCREASE IN MILITARY EXPENDITURES. ASSESSMENT OF DONOR REACTION IS DIFFICULT BECAUSE MUCH DEPENDS ON DONOR PERCEPTION OF (1) THE ROLE OF THE MILITARY IN MODERNIZING ETHIOPIA, (2) EPMG'S COMMITMENT TO ECONOMIC DEVELOPMENT PROGRAMS, AND (3) ETHIOPIA'S DEFENSE NEEDS. IT DOES NOT SEEM IMPRUDENT TO ASSUME THAT DONORS WILL CONTINUE THEIR PROGRAMS AS LONG AS THE EPMG PURSUES MODERATE ECONOMIC AND POLITICAL POLICIES AND MAINTAINS ITS COMMITMENT TO DEVELOPMENT PROGRAMS AS HISTORIC LEVELS OR HIGHER.

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